

U.S. ECONOMICS

Ethan S. Harris 1.212.526.5477 eharris@lehman.com
Joseph T. Abate 1.212.526.0067 jabate@lehman.com

Automatic Pilot

Outlook at a Glance...

%	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	2004	2005	2006
Real GDP	4.0	3.1	3.7	3.7	3.3	3.3	4.4	3.5	3.3
Domestic final sales	5.1	4.4	3.3	3.6	3.1	3.1	4.6	3.8	3.2
Inventories	-1.0	0.4	0.3	0.1	0.0	0.0	0.4	0.1	0.0
Net trade	-0.1	-1.7	0.1	0.0	0.2	0.2	-0.7	-0.3	0.1
Unemployment rate	5.4	5.4	5.3	5.2	5.2	5.2	5.5	5.2	5.2
Non-farm payrolls, 000	134	202	170	165	160	160	186	164	159
Consumer prices	2.7	3.4	3.0	2.6	2.6	2.6	2.7	2.7	2.5
Core CPI	1.8	2.1	2.3	2.3	2.5	2.5	1.8	2.4	2.7
Fed funds	1.75	2.25	2.75	3.25	3.50	3.50	2.25	3.50	4.00
TSY 2-year note	2.53	2.81	3.30	3.55	3.65	3.80	2.81	3.80	4.20
TSY 5-year note	3.50	3.49	3.75	4.10	4.20	4.30	3.49	4.30	4.40
TSY 10-year note	4.29	4.16	4.25	4.70	4.90	5.00	4.16	5.00	5.40

Notes: Real GDP and its contributions are seasonally-adjusted annual rates. Unemployment is measured as a percentage of the labour force. Inflation measures are y-o-y percent changes. Interest rate forecasts are end-of-period. Payrolls are monthly average changes. Table last revised January 28. All forecasts are modal forecasts (ie, the single most likely outcome).

Source: Lehman Brothers

Snooze Bar

We expect no surprises from
the Fed.

The upcoming Fed meeting could be one of the least interesting in recent memory. The futures market is fully pricing in a 25-basis-point hike and our Fediscope model is suggesting about a 75% chance of another 25-basis-point hike in March (with about 20% of no change and 5% of a 50-basis-point hike). There is also little reason for the Fed to change its language: "output appears to be growing at a moderate pace," "labor market conditions continue to improve," and "inflation expectations remain well contained", so "policy accommodation can be removed at a pace that is likely to be measured." The only interesting part of the meeting will be a preliminary discussion of inflation targeting, but we will not learn much about that discussion until the minutes are released.

Lehman Brothers does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.

Investors should consider this report as only a single factor in making their investment decision.

PLEASE REFER TO THE BACK COVER FOR ANALYST CERTIFICATION AND IMPORTANT DISCLOSURES.

Monetary conditions have eased as the Fed has tightened.

Unless financial markets start responding to Fed moves, the Fed will likely remain on auto pilot. The hikes thus far have had remarkably little impact on financial markets. Even with the increased use of variable rate debt, the most important channels of monetary policy are long-term interest rates, the stock market and the dollar. More recently, housing wealth could be added to the equation. Like other economists, we have developed a "monetary conditions" index which combines the real Fed funds rate, the trade-weighted dollar and the stock market, with weights calibrated to capture their relative importance for the economy. As Figure 1 shows, while monetary conditions have tightened modestly, they remain quite loose by historical standards. Macroeconomic Advisers has developed a more comprehensive measure that distinguishes between short- and long-term interest rates. Their measure shows monetary policy providing almost a 4 percentage point stimulus to the economy, marking the strongest reading since 1987 and almost one percentage point more stimulative than at the start of the rate cycle.

The Fed does not want to damage the economy. They also probably recognize that the economy could not handle a normalization of financial conditions. But the Fed is unlikely to pause in its rate hikes until the markets take notice.

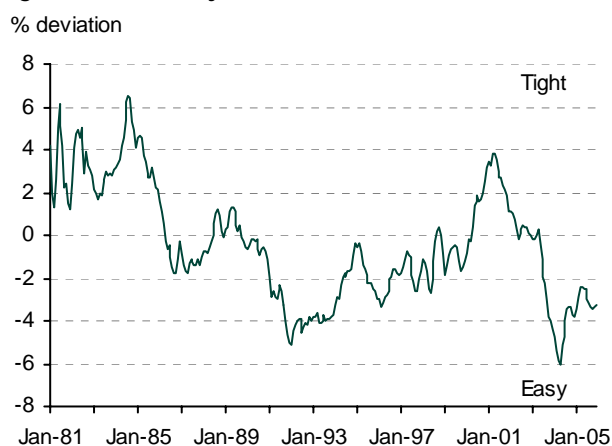
Priced for Perfection

While there may be good technical reasons for low bond yields, for the Fed, the biggest surprise in financial markets in recent months has been the resilience of the bond market. Figure 2 compares the current rate cycle to four previous cycles under Chairman Greenspan. Eight months into this cycle and the Fed has tightened by only 25 basis points less than average. Yet, as Figure 3 shows, the bond market has been anything but average: at this stage in past cycles 10-year yields were up 50 basis points to 150 basis points, while in this cycle yields are down about 50 basis points.

The Fed's sugar coating has taken the bitter taste out of tightening.

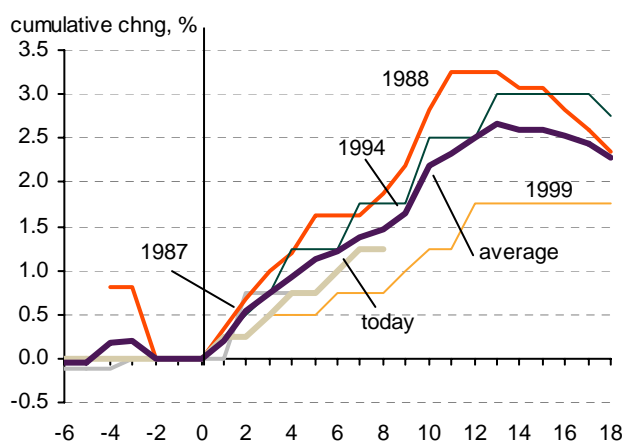
One reason for the market's resilience is that the Fed may have been too successful in easing the pain of rate hikes. Apparently the Fed's new policy of "transparency" has taken the shock value out of monetary policy. The Fed and business economists all seem to have very similar forecasts for growth and inflation. And the Fed is promising to forewarn the markets if there is any change of plan. This, in turn, implies reduced volatility, reduced risk premiums and greater willingness to extend duration and buy riskier assets.

Figure 1: Monetary Conditions Index



Source: Lehman Brothers

Figure 2: Federal Funds Rate



Source: Bloomberg and Lehman Brothers

*The Fed's measured pace
promise means a lot less than
it seems.*

In reality, the world is still a risky place. The Fed's measured pace promise means a lot less than it appears on the surface. In the directive, the Fed is careful to keep its options open: "Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability." And the promise is only good as long as the data remain close to forecasts. While both the real economy and inflation are less volatile than they were 20 years ago, we should not be fooled by the tight consensus around the U.S. forecast: Within those forecasts, a normal level of uncertainty exists.

Regime Risk

*The bond market is
vulnerable if there is a poor
replacement for Chairman
Greenspan....*

The bond market is also vulnerable to two kinds of regime risk. First, Alan Greenspan's chairmanship ends in one year. There are plenty of able replacements who understand the importance of maintaining the Fed's independence and consolidating the victory against inflation. Several of the current Fed Governors would be effective. However, the chairmanship is a political appointment—nominated by the President and confirmed by the Senate. Independent-minded economists have not fared well in the Bush administration. We cannot rule out appointment of a "business friendly" Fed Chairman similar to G. William Miller in the 1970s.

*...or if overseas investors
hesitate to finance the twin
deficits.*

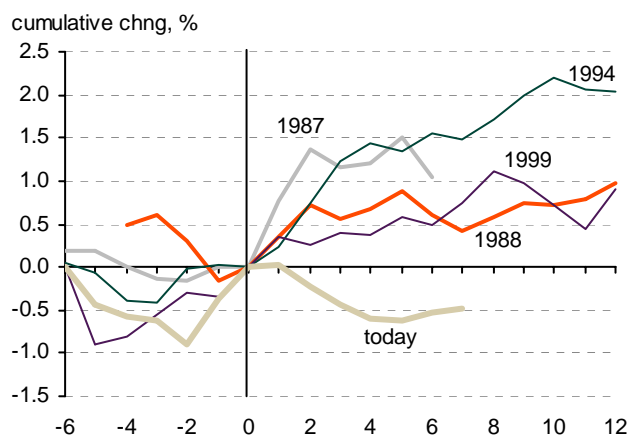
A second, equally important, regime risk involves the huge twin deficits. Under normal circumstances, a country running large and rising deficits would have to pay a significant premium to borrow in global financial markets. Aggressive buying by Asian central banks has given the United States a free ride in this regard. However, this makes the dollar and the bond market vulnerable to any hint of an interruption of the flow.

Nothing Micro About It

*The Microsoft dividend
temporarily boosts measured
savings.*

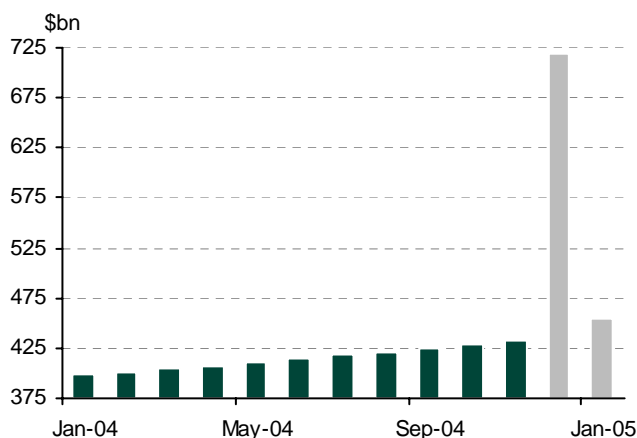
Microsoft's \$32 billion special dividend paid out on December 2 will distort a variety of indicators including the income and saving data released in the week ahead. Since personal income includes dividend receipts, we expect personal income to jump roughly 3% in December (Figure 4). This should cause a spike in the saving rate since most of it will not be spent immediately and any taxes owed will be paid in April.

Figure 3: 10-Year Treasury Yields



Source: Bureau of Economic Analysis and Lehman Brothers

Figure 4: Personal Dividend Income



Source: Bureau of Labor Statistics and Lehman Brothers

The Week Ahead

We look for a solid gain in non-farm payrolls in January, with a flat reading on the unemployment rate. We also look for a temporary blip in the saving rate due to the payment of the Microsoft dividend and an unsurprising rate hike from the Fed.

Personal Income (Monday)

We expect personal income to post a very large gain this month...

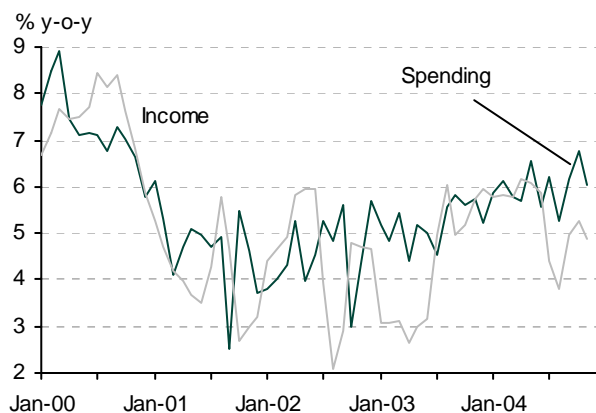
...because of the Microsoft dividend.

The personal income figures are likely to be distorted by Microsoft's December 2 dividend payment of \$32 billion, which we expect to push income up 4.0% in the month. Absent the dividend, personal income would have risen only a modest 0.3%, amid a longer work week and a small (0.1%) gain in average hourly earnings.

The Bureau of Economic Analysis has noted that roughly three-quarters of the \$32 billion payment will show up in the personal income statistics for the month of December. The remainder is expected to leak overseas and to state and local governments. Annualizing this payment produces a huge impact on personal income of almost \$290 billion, or the nearly \$100 billion at a quarterly rate that showed up in Friday's GDP statistics. Since most of these funds were received in December, with little time for households to make appropriate tax payments, we judge that disposable income will increase by roughly the same amount.

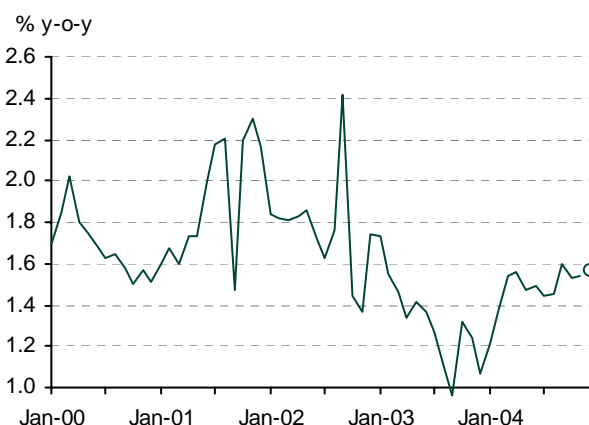
Such a large increase in personal income will likely boost the personal savings rate from almost 0% to 3.0%, in our view. In fact, without the dividend, we estimate the savings rate would have crossed into negative territory for the first time since the Depression (the savings rate went negative in October 2001 due to accounting issues surrounding the payment of insurance benefits after the terror attacks). As a result, the dividend is providing the household sector with only a temporary reprieve—consumption growth continues to outstrip growth in incomes (Figure 5).

Figure 5: Consumption and Income



Source: Bureau of Economic Analysis and Lehman Brothers

Figure 6: Core PCE Deflator



Source: Bureau of Economic Analysis and Lehman Brothers

We expect personal consumption expenditures to rise by 1.0%, driven higher by a sharp increase in unit auto sales. During December, unit sales rose by more than 12% as dealers offered aggressive incentives and price discounts to lure buyers onto dealer lots. Weaker holiday sales may, in our judgment, restrain non-auto spending. But we predict spending on services will also be fairly solid in the month—up 0.4% compared with a gain of 0.6% in November. Elsewhere, we predict the core PCE deflator to rise by 0.2%, somewhat faster

than its recent trend. On a year-over-year basis, the core PCE deflator will have risen 1.6% in 2004 compared with 1.1% in 2003 (Figure 6).

New Home Sales (Monday)

We look for new home sales to increase slightly in December, rising 2.2% to a 1.150-million-unit annualized rate. The anticipated December rebound is partly an unwind from the steep plunge registered in November, when sales fell by an unusually steep 12%. Other housing market indicators remain firm, with homebuilder surveys and anecdotal sales reports all pointing to a strong sales as mortgage rates remain attractive.

Chicago PMI (Monday)

We look for the Chicago PMI to fall to 59.5.

We look for the Chicago area purchasing managers' index to fall further in January—slipping from 61.2 in December to 59.5. The January reading would be the index's lowest reading since last August.

Activity in the Chicago area has come under pressure from a planned cooling in auto output in the first quarter. However, the most recent *Beige Book* reported that other manufacturing sectors were "steady at robust levels" as new orders for capital equipment, machinery, and parts remained strong. This strength should be sufficient to keep the PMI well above 50 this month and possibly higher than our forecast of 59.5. The *Beige Book* also reported that fewer employers were laying off workers but that the rate at which firms were converting temporary workers to full-time employees had cooled so that there may not be much movement in the January employment index.

Construction Expenditures (Tuesday)

Construction expenditures are expected to rise by 0.5%.

We reckon construction expenditures will rise by 0.5% in December, offsetting their 0.4% November decline. Most of the anticipated rebound should come from new residential building. Like the rest of the housing market, residential construction spending remains red hot as mortgage rates remain near historic lows. Weather effects may compound the increase in construction expenditures as new home construction and home improvements delayed by the stormy weather in November were probably pushed into December. Other private and public sector spending is also expected to be solid this month.

ISM (Tuesday)

We look for the ISM to fall slightly.

We project the overall ISM to slip 0.6 to 58.0 in January—a level roughly in line with the index's average since last August, but quite elevated by historical standards (Figure 7). Indeed, ISM readings near these levels have usually been associated with GDP growth of more than 5%.

Of the components this month, we will be paying the most attention to the orders index. This crept about 3 points higher between the end of 3Q and December—most likely because of the surge in business demand for capital equipment in advance of the expiration of the bonus depreciation tax cut. We will be curious to see if the index falls in January following the expiry of the tax cuts. Anecdotal reports suggest that plenty of the 4Q orders momentum carried forward into January, but this remains to be verified in the official data. Even so, the index ended 2004 at a very robust level of 62.5.

Domestic Vehicle Sales (Tuesday)

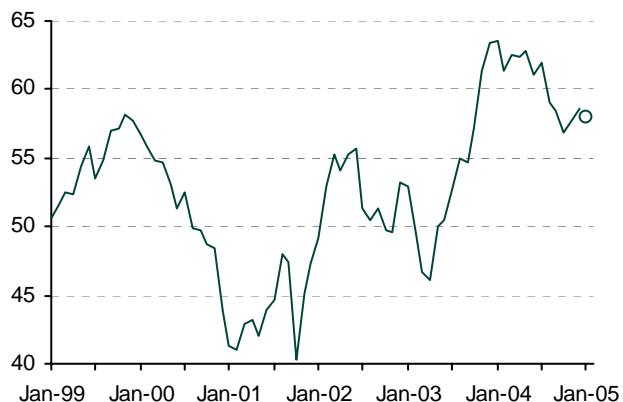
Domestic sales likely fell steeply in January.

We predict domestic vehicles sales will retreat sharply in January following a particularly robust December. We expect domestic sales to pull back 15%, from 14.6 million units to 12.4 million. Including imports will do little to change the picture: Instead, we look for overall auto sales to reach only 15.6 million units, well below last month's 18.3 million and the 2004 average monthly sales pace of 16.8 million (Figure 8). Our view is that the strong sales pace

in December “borrowed” a bit from January, pulling sales one month forward that might otherwise have occurred in January. Such a pause is not uncommon in monthly sales data.

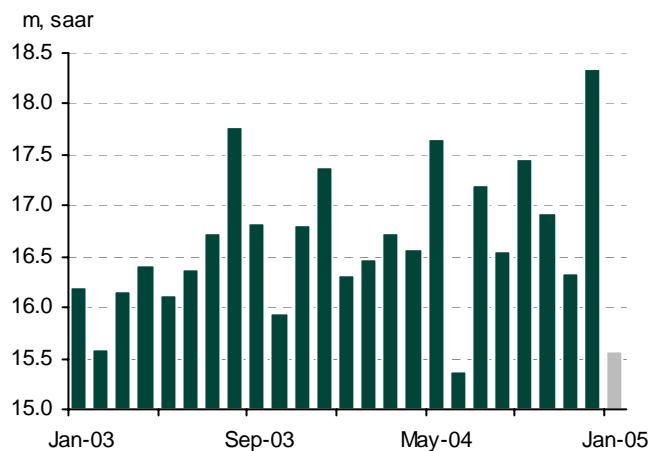
However, with interest rates still fairly low and expected to remain so in the near term, we reckon sales will quickly bounce back in February. It is probably best to look at the average of December and January sales to gauge overall demand—which at 17 million units is extremely solid.

Figure 7: ISM



Source: Institute of Supply Management and Lehman Brothers

Figure 8: Total Vehicle Sales



Source: Commerce Department and Lehman Brothers

Quarterly Refunding Announcement (Wednesday)

The Treasury will announce its mid-quarter refunding plans on Wednesday morning. We predict a fairly ho-hum offering with few surprises and no change from the November sales. In particular, we expect the Treasury to sell \$51.0 billion worth of securities: \$22 billion in 3-year notes, \$15 billion in 5-year notes, and \$14 billion in 10-year notes. As the auction calendar is fine for now, given the Treasury's financing needs, we do not expect any major announcements to be made at this week's refunding announcement.

FOMC Rate Announcement (Wednesday)

We look for the Fed to raise rates another 25 basis points.

The inflation risks statement is likely to remain balanced.

We expect the Federal Reserve to raise the funds rate another 25 basis points on its continued path toward “measured” tightening. And while we do not anticipate any changes in the language of the statement, two days of debate could produce some tweaking.

Behind the closed doors, we expect some disagreement on the outlook for inflation. The minutes from the December meeting revealed some divergence of opinion, with some members concerned that the excess capacity which had been restraining price pressures has all but evaporated. Others, however, noted that there were still no signs yet of a pick-up in wages and that capacity utilization is still below normal inflation trigger points. As a result, we think it is probably too soon to expect the Fed to switch to a skewed inflation risks statement—at least until there are stronger signs of a further deterioration in core inflation.

It was reported in *The Wall Street Journal* this week, that the Fed would also be debating the merits of having an explicit inflation target. This would not be the first time that the topic has come up at an FOMC meeting—it was last broached in 1996. However, so long as Mr Greenspan is Chair, we doubt the Fed is willing to give up much of its autonomy by implementing an explicit inflation target. Instead, our sense is that this will be more of a long-range discussion for consideration after Greenspan's departure next year.

The excesses statement is likely to be discussed...but it probably will not lead to any change in policy yet.

Likewise, we expect the FOMC to discuss at length the concern expressed at the December meeting that excessive liquidity was causing a binge of speculation and risk-taking behavior—as evidenced by narrowing corporate spreads and anecdotal reports of speculative activity in the housing market. The Fed appears to have become worried that the markets took these concerns too literally, as at least six different officials hit the wires last week downplaying these concerns. And while they may do so at the February FOMC meeting, we think they are not quite ready to dismiss them entirely. Instead, their primary concern seems to be the fact that financial conditions generally—and long Treasury rates, in particular—have failed to react as they would have expected, with the yield curve flattening and not providing much of a restraint on aggregate economic activity. We believe it is much too soon for the Fed to contemplate increasing the pressure—either by changing the language of its statement, or, even more aggressively, moving to 50-basis-point hikes. Nevertheless, as several Fed officials have reminded the market in the past few weeks, a “measured” pace toward tightening only applies so long as inflation is under control, growth is at or near potential and there are few signs of speculative excesses building up in the economy. Our view is that the Fed is still some way from upping the ante and that 25-basis-point rate hikes and no changes to the statement will be the order of the day—for at least the next two FOMC meetings.

Initial Jobless Claims (Thursday)

We look for jobless claims to rise by 5,000 to 330,000 in the week of January 29.

Non-Farm Productivity (Thursday)

Productivity is expected to rise 0.7%.

We estimate non-farm productivity rose by 0.7% in 4Q, or at an annual rate of 2.5% in 2004 compared with 5.7% in 2003. With productivity growth of 0.7% and a mild 3% gain projected in non-farm compensation costs, we estimate unit labor costs will probably rise by 2.3% (Figure 9). On a year-over-year basis, unit labor costs are up about 1%, having accelerated from -0.2% in 2003.

Non-farm productivity growth has been cooling all year as output growth picked up and the ability of firms to extract additional efficiency gains from their workers was tapped out. As we have argued before, most of the recent acceleration in productivity growth has come from multi-factor gains like better, more integrated technology and more efficient management techniques. But these gains are finite—without an acceleration in capital deepening (or applying more capital to the existing labor force), it is nearly impossible to sustain productivity growth rates of over 5% for long.

The anticipated deceleration in productivity growth this year is one of the Fed's key worries respecting the inflation outlook. And while there are few signs that compensation costs are getting out of control, higher benefits expenses have pushed them higher—at roughly a 4% annual rate, suggesting that profit margins will come under further pressure and that the risk of pass-through effects to consumer prices is greater.

Non-Manufacturing Purchasing Managers' Index (Thursday)

We predict the non-manufacturing purchasing managers' index will retreat 3 points to 60.0 in January. The index has been volatile lately, so it has been hard to get a clear reading on the economy. In addition the index's correlation with GDP growth and other, more explicit measures of growth and expenditures, has always been somewhat checkered. Despite these shortcomings, a reading of 60 or higher is still broadly consistent with solid GDP growth.

Factory Orders (Thursday)

We expect factory orders to rise by 1%...

We expect factory orders to be up 1.0% in December, slightly lower than November's 1.2% increase. The headline durable goods orders figure, which comprises about half of total factory orders, rose 0.6% in the month. This was likely matched by a strong gain in non-durable goods orders, reflecting a combination of strong demand and higher prices. Meanwhile, we

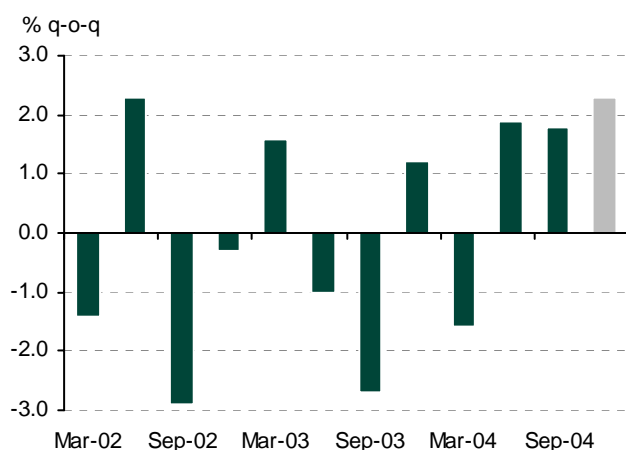
look for inventories to rise 0.5%, with shipments up 1.5%, which would further depress the already historically low inventory shipments ratio.

Employment (Friday)

We look for a fairly healthy employment report for January, with non-farm payrolls rising 180,000 and the unemployment rate holding steady at 5.4% for the third consecutive month. Our expectation is for average hourly earnings to increase just 0.2% (or 2.6% year-over-year)—this is unlikely to be a report that troubles the Fed much.

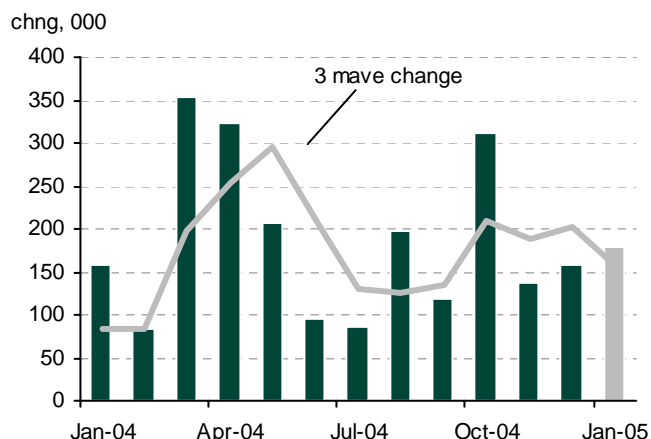
We expect non-farm payrolls to rise by 180,000 in January, which is roughly consistent with the three-month moving average rate of hiring and with a moderate economic expansion (Figure 10). Among the components, we expect most of the strength this month to come from rebounds in construction, retail trade, and temporary help hiring. Last month's soft holiday shopping season and poor weather restrained hiring across all three sectors, with retail jobs shrinking by 20,000 and temporary help and construction expanding by only 9,000 and 7,000, respectively. Combined, we reckon these sectors will increase payrolls by at least 65,000 in January. Unfortunately, there have been few signs that manufacturers are gearing up—employment growth has been soft since summer and the factory work week has languished at 40.5 hours for the past two months. Our guess is that factories will ramp up hours before returning to hiring, with the recent surge in orders likely leading to an increase in the factory work week to 40.6 hours this month from 40.5 in December.

Figure 9: Non-Farm Unit Labor Costs



Source: Bureau of Labor Statistics and Lehman Brothers

Figure 10: Non-Farm Payrolls



Source: Bureau of Labor Statistics and Lehman Brothers

...with the non-farm work week holding steady at 33.8.

The BLS will revise the household and establishment figures this month.

Elsewhere in the establishment survey, we look for the overall work week to hold steady at 33.8 hours. The work week has been locked between 33.6 and 33.8 hours since October 2002, so any increase this month would represent a substantial improvement in the labor market. The combination of a flat work week and a 180,000-job increase in hiring translates into a 0.1% increase in the aggregate hours index. This supply-side GDP measure is set to rise 2.1% in 1Q which—given our assumptions about labor productivity growth—is broadly in line with the expenditures-based GDP estimate of 3.7%.

This month, the Bureau of Labor Statistics will revise the household and establishment figures. The household statistics will reflect an update of the population controls—or blow-up factors the BLS uses to inflate its survey to reflect the overall civilian non-institutional population. We believe the population controls are overstating the true level of population and thereby understating the participation rate, which has remained dismally low since before the 2001 recession. How much of a revision is likely is unclear as is the expected improvement to the

participation rate. Instead, a full explanation of the persistently low participation rate may have to wait several years until the 2010 population census is completed.

At the same time, the BLS will benchmark the payroll data against the state unemployment insurance tax collection figures. This revision is meant to capture hiring that occurs in firms that are too small or recently created to have been captured by the official BLS survey. Preliminary calculations suggest that the revision is likely to be relatively small—roughly 236,000 jobs, or just under 20,000 per month. We do not expect either revision to have much of an influence on the overall tone of the labor market.

Consumer Sentiment (Friday)

We expect the final January reading on consumer sentiment to hold near the preliminary value released two weeks ago. We look for sentiment to hold steady at 96.0 in January as economic conditions continue to improve and expectations about the future strengthen.

New York
745 Seventh Avenue
New York, NY 10019 USA
1.212.526.7000

London
25 Bank Street
London E14 5LE England
44.20.7102.1000

Tokyo
6-10-1 Roppongi
Minato-ku Tokyo 106-6131 Japan
813.6440.3000

Hong Kong
One Pacific Place
88 Queensway, Hong Kong
852.2869.3000

Analyst Certification

I, Ethan S. Harris, hereby certify that (1) the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Important Disclosures:

The analysts responsible for preparing this report have received compensation based upon various factors including the Firm's total revenues, a portion of which is generated by investment banking activities.

This material has been prepared and/or issued by Lehman Brothers Inc., member SIPC, and/or one of its affiliates ("Lehman Brothers") and has been approved by Lehman Brothers International (Europe), authorized and regulated by the Financial Services Authority, in connection with its distribution in the European Economic Area. This material is distributed in Japan by Lehman Brothers Japan Inc., and in Hong Kong by Lehman Brothers Asia Limited. This material is distributed in Australia by Lehman Brothers Australia Pty Limited, and in Singapore by Lehman Brothers Inc., Singapore Branch. This material is distributed in Korea by Lehman Brothers International (Europe) Seoul Branch. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy the securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Lehman Brothers. With the exception of disclosures relating to Lehman Brothers, this research report is based on current public information that Lehman Brothers considers reliable, but we make no representation that it is accurate or complete, and it should not be relied on as such. In the case of any disclosure to the effect that Lehman Brothers Inc. or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company, the computation of beneficial ownership of securities is based upon the methodology used to compute ownership under Section 13(d) of the United States' Securities Exchange Act of 1934. In the case of any disclosure to the effect that Lehman Brothers Inc. and/or its affiliates hold a short position of at least 1% of the outstanding share capital of a particular company, such disclosure relates solely to the ordinary share capital of the company. Accordingly, while such calculation represents Lehman Brothers' holdings net of any long position in the ordinary share capital of the company, such calculation excludes any rights or obligations that Lehman Brothers may otherwise have, or which may accrue in the future, with respect to such ordinary share capital. Similarly such calculation does not include any shares held or owned by Lehman Brothers where such shares are held under a wider agreement or arrangement (be it with a client or a counterparty) concerning the shares of such company (e.g. prime broking and/or stock lending activity). Any such disclosure represents the position of Lehman Brothers as of the last business day of the calendar month preceding the date of this report. This material is provided with the understanding that Lehman Brothers is not acting in a fiduciary capacity. Opinions expressed herein reflect the opinion of Lehman Brothers and are subject to change without notice. The products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. If an investor has any doubts about product suitability, he should consult his Lehman Brothers representative. The value of and the income produced by products may fluctuate, so that an investor may get back less than he invested. Value and income may be adversely affected by exchange rates, interest rates, or other factors. Past performance is not necessarily indicative of future results. If a product is income producing, part of the capital invested may be used to pay that income. © 2005 Lehman Brothers. All rights reserved. Additional information is available on request. Please contact a Lehman Brothers entity in your home jurisdiction.

Lehman Brothers policy for managing conflicts of interest in connection with investment research is available at www.lehman.com/researchconflictspolicy. Ratings, earnings per share forecasts and price targets contained in the Firm's equity research reports covering U.S. companies are available at www.lehman.com/disclosures.

Complete disclosure information on companies covered by Lehman Brothers Equity Research is available at www.lehman.com/disclosures.